Supreme Court, U.S.
FILED
MAR 17 1986
JOSEPH F. SPANIOL, JR.
CLERK

No. 85-1196

IN THE

Supreme Court of the United States

OCTOBER TERM, 1985

CITY OF CHARLOTTESVILLE, VIRGINIA,
Petitioner,

v.

FEDERAL ENERGY REGULATORY COMMISSION,
COLUMBIA GAS TRANSMISSION CORPORATION,
COLUMBIA GULF TRANSMISSION COMPANY,
INTERSTATE NATURAL GAS
ASSOCIATION OF AMERICA,
Respondents.

On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The District Of Columbia Circuit

BRIEF IN OPPOSITION OF RESPONDENT INTERSTATE NATURAL GAS ASSOCIATION OF AMERICA

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March 17, 1986

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QUESTION PRESENTED

Whether the particular method used by the Federal Energy Regulatory Commission to compute the federal income tax allowance recoverable in the rates of pipelines which join with affiliated companies in filing consolidated tax returns was a policy choice which the Commission has authority to make and which was well within the bounds of reasoned decisionmaking based on the facts before it.

List Of Members Of
Interstate Natural Gas Association Of America
Pursuant to Rule 28.1

Member Companies

Alabama-Tennessee Natural Gas Company
Algonquin Gas Transmission Company
Arkla Energy Resources Company
The Coastal Corporation
The Columbia Gas System, Inc.
Consolidated Natural Gas Company
El Paso Natural Gas Company
Granite State Gas Transmission Inc.
Great Lakes Gas Transmission Company
HNG-InterNorth
Kentucky West Virginia Gas
KN Energy, Inc.
Locust Ridge Gas Company
Michigan Gas Storage Company
MidCon Corp.
Mountain Fuel Resources, Inc.
Northwest Energy Company
Pacific Gas Transmission Company
Pacific Interstate Transmission Company
Panhandle Eastern Corporation
Ringwood Gathering Company
Southern Natural Gas Company
Tennessee Gas Transmission Company
Texas Eastern Gas Pipeline Company
Texas Gas Transmission Corporation
Texas Oil & Gas Corporation
Transcontinental Gas Pipe Line Corporation
Valero Interstate Transmission Company
Valley Gas Transmission, Inc.

Associate Member Companies

Amoco Production Company
ARCO Oil and Gas Company

Atlanta Gas Light Company
The Brooklyn Union Gas Company
Champlin Petroleum Company
Chevron USA
Cities Service Oil and Gas Corporation
Conoco Inc.
Entex, Incorporated
Exxon Company, U.S.A.
Forest Oil Corporation
Gulf Oil Exploration and Production Company
John H. Hill
Kerr-McGee Corporation
Kinsey Interests, Inc.
Laclede Gas Company
Lear Petroleum Exploration Company
Marathon Oil Company
Minerals, Inc.
Mitchell Energy & Development Corporation
National Fuel Gas Company
NUI Corporation
Phillips Petroleum Company
Shell Oil Company
Southern California Gas Company
Sun Exploration & Production Company
Texaco U.S.A.
Unocal Corporation

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BRIEF IN OPPOSITION OF RESPONDENT INTERSTATE NATURAL GAS ASSOCIATION OF AMERICA

Respondent Interstate Natural Gas Association of America (INGAA)[1] respectfully urges that this Court

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[1]Respondent INGAA is a non-profit national trade association whose membership includes virtually all of the major natural gas pipeline companies subject to the Federal Energy Regulatory Commission's jurisdiction under the Natural Gas Act, 15 U.S.C. §§ 717, *et seq.* (1982). For many years, INGAA has appeared in

deny the petition of the City of Charlottesville (City) for a writ of certiorari seeking review of the decision of the United States Court of Appeals for the District of Columbia Circuit in this case. That opinion is reported at 774 F.2d 1205.[2]

STATEMENT OF THE CASE

This case arises out of rate proceedings before the Federal Energy Regulatory Commission (Commission) under Section 4 of the Natural Gas Act, 15 U.S.C. § 717c (1982). The question presented involves Petitioner City's challenge below to the Commission's formula for computing the appropriate income tax allowance which a pipeline is entitled to recover in its rates. More specifically, the ratemaking formula at issue is one by which the Commission segregates and allocates to the regulated pipeline its share of the various elements of income tax calculus which, under the Internal Revenue Code, the pipeline company and its affiliated companies are permitted to aggregate by filing a single consolidated income tax return.

City has maintained throughout these proceedings that the so-called "actual taxes paid" principle requires that the Commission calculate the pipeline's tax allowance using the effective tax rate derived from these consolidated returns. According to City, it is only the resulting tax liability reflected in the con-

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rulemaking, rate and certificate proceedings before the Commission and the courts when issues affecting the general interests of its members and of the natural gas industry were involved. The case below was such a proceeding.

[2]References in this Brief in Opposition to specific pages of the Court of Appeals decision and to specific pages of the other decisions below will be to the Federal Reporter and to the Appendix (App.) filed with the Petition (Pet.).

solidated tax return which is actually paid and which therefore must be reflected in the tax allowance for ratemaking purposes. According to City, this overall *average* effective tax rate would operate to assign to the pipeline affiliate a *pro rata* share (or average level) of income taxes incurred by the consolidated group. App. at 42a and 52a.

The Commission below rejected City's position and chose to continue its policy of allocating consolidated income taxes on the basis of the "stand alone" method, *i.e.*, that for ratemaking purposes, "a utility [is] considered as nearly as possible on its own merits and not on those of its affiliates," a policy consistently followed by the Commission since its 1972 decision in *Florida Gas Transmission Co.*, 47 F.P.C. 341, 363. Utilizing this principle, the Commission calculated the regulated pipeline's income tax allowance on the basis of the income and deductions attributable to the pipeline.

The "stand alone" method, however, does *not* determine the tax allowance "as if the pipeline were an independent entity filing a separate tax return," as Petitioner City asserts (Pet. at 7-8). See generally App. at 49a-51a. In fact, in this case, the Commission determined that tax savings arising out of the parent company's interest deductions were attributable to, and therefore to be shared by, the affiliated pipeline entity and its customers.

As to City's position that average, *pro rata* taxes were required as a matter of "actual taxes paid," the Commission rejected this method in that it is oblivious to the constituent elements giving rise to the consolidated tax liability; it makes no effort whatsoever to discern which elements are attributable to the jurisdictional service being priced. App. at 55a.

When this case first appeared before the Court of Appeals on review, Petitioner City contended that the Commission's "stand alone" policy exceeded its legal authority, which authority was constrained by the theory of "actual taxes paid," a principle purportedly established by this Court in *FPC* v. *United Gas Pipe Line Co.*, 386 U.S. 237 (1967). The Court of Appeals expressly rejected this contention, holding that the Commission had the "legal authority to do what it did in this case, [but that] it lacked factual support for [its] Orders." *City of Charlottesville* v. *FERC,* 661 F.2d 945, 953 (D.C. Cir. 1981) (footnote omitted) ("*Charlottesville I*"). Thus, while the court remanded the case to the Commission "for further consideration" (661 F.2d at 947), the court made clear that contrary to City's interpretation of United, "[t]he Commission is not obligated to follow any particular formula for the apportionment of consolidated tax savings" (661 F.2d at 952) (footnote omitted).

On remand, the Commission convened further hearings at which an exhaustive evidentiary record was compiled. Based on this record, the Commission reaffirmed its "stand alone" policy and, in so doing, "reconsidered the policy question from the ground up" (App. at 44a, n. 8). In reaffirming its policy, the Commission discussed at length its cost allocation philosophy and explained in detail how its application of the "stand alone" method in this case was based upon well established principles of cost responsibility. App. at 38a-98a.

City again appealed to the court below, and *again* the court (by yet a different panel) rejected City's contention that "the stand-alone methodology is *per se* unlawful because the Commission can properly consider only 'actual taxes paid.'" *City of Charlottesville* v. *FERC,* 774 F.2d at 1213 ("*Charlottesville II*"), App.

at 15a. This time, however, the court below upheld the Commission's application of that method to the facts, concluding that the Commission's choice of method here "is an entirely reasonable one, beyond our authority to upset." *Charlottesville II*, 774 F.2d at 1221, App. at 32a.

In seeking this Court's review, Petitioner City again urges its theory of "actual taxes paid," however, apparently now it has abandoned its contention below that this principle requires that the effective tax rate be used to calculate the income tax allowance. Pet. at 9. Apparently Petitioner's position before this Court is "that there be *some* equitable sharing of these [consolidated tax] savings" (*id.*), although Petitioner will not say *what* share.

Respondent INGAA respectfully submits that this is not a case warranting this Court's review.

REASONS WHY THE PETITION SHOULD BE DENIED

I. THE COURT OF APPEALS DECISION BELOW IS IN FULL ACCORD WITH THIS COURT'S *UNITED* DECISION

The basic question decided by the Court of Appeals below was whether the method used by the Commission to compute the federal income tax allowance included as part of the cost of service recoverable in the rates of two interstate natural gas pipelines was proper. The Court of Appeals correctly found that the Commission's "stand alone" method, by which the Commission segregated and allocated to the pipelines their share of the various income tax elements which they and their affiliated companies are entitled to aggregate within a single consolidated income tax return, was a proper exercise of the Commission's ra-

temaking authority based on substantial record evidence and reasoned decision-making.

In *United,*[3] this Court was confronted with the same question concerning a different allocation method and concluded that "we cannot say that the method the Commission chose to allocate the tax liability among the group members was erroneous or contrary to its statutory authority" (386 U.S. at 245). Indeed, as to such matters of cost allocation, this Court in *United* went on to say: "'When Congress, as here, fails to provide a formula for the Commission to follow, courts are not warranted in rejecting the one which the Commission employs unless it plainly contravenes the statutory scheme of regulation.'" 386 U.S. at 246, quoting *Colorado Interstate Gas Co.* v. *FPC,* 324 U.S. 581, 589 (1945).

The reasons for these limits on judicial review of the Commission's rate-making function were further explained by the Court in the quoted *Colorado Interstate* decision as follows (324 U.S. at 589-90):

> Allocation of costs is not a matter for the slide-rule. It involves judgment on a myriad of facts. It has no claim to an exact science. . . . Under this Act the appropriateness of the formula employed by the Commission in a given case raises questions of fact not of law.

Petitioner City does not deny that, as in *United,* the formula challenged below is also one for the allocation of consolidated income tax costs. Nor does City suggest that the Commission's statutory rate-making function, and judicial review thereof, under

[3]*FPC* v. *United Gas Pipe Line Co.*, 386 U.S. 237 (1967).

the Natural Gas Act have in any way changed since this Court's decision in *United.*

Yet, Petitioner City contends that in upholding the Commission's allocation formula below, the Court of Appeals contravened this Court's opinion in *United.* According to City, this Court's reasoning in *United requires* that certain consolidated tax savings be allocated to the pipelines for flow-through to their customers. Thus, City contends that the Court of Appeals erroneously dismissed as *dicta* the reference in *United* to "the power and the duty of the Commission to limit cost of service to real expenses" (386 U.S. at 245). That City misreads *United* is, however, plain on its face.

In *United,* the court below had set aside the Commission's formula as having impermissibly considered the pipeline's participation in a consolidated return with its nonregulated affiliates, "contrary to the requirements which Congress had imposed." *United Gas Pipe Line Co.* v. *FPC,* 357 F.2d 230, 231 (5th Cir. 1966). That court had followed the decision of the United States Court of Appeals for the Tenth Circuit in *Cities Service Gas Co.* v. *FPC,* 337 F.2d 97 (1964) which, relying upon *Colorado Interstate, supra,* and *Panhandle Eastern Pipeline Co.* v. *FPC,* 324 U.S. 635 (1945), had held that the Commission's tax allocation formula exceeded jurisdictional limits which require

> a separation of profits and losses between regulated and nonregulated businesses in determining the tax allowance includible in the cost of service of the regulated company. "Otherwise the profits or losses, as the case may be, of the unregulated business would be assigned to the regulated business and the Commission would transgress the jurisdictional lines which Congress wrote into the

> Act." *Panhandle Eastern Pipe Line Co.* v. *F.P.C., supra,* 324 U.S. p. 641, 65 S.Ct. p. 825.

Cities Service, 337 F.2d at 101.

Significant to the question presented here, it was precisely this holding of *Cities Service* which this Court in *United* was expressly addressing (386 U.S. at 242) when it stated (386 U.S. at 244-45):

> But when the out-of-pocket tax cost of the regulated affiliate is reduced, there is an immediate confrontation with the ratemaking principle that limits cost of service to expenses actually incurred. Nothing in *Colorado Interstate* or *Panhandle* forbids the Commission to recognize the actual tax saving impact of a private election to file consolidated returns. On the contrary, both cases support the power and the duty of the Commission to limit cost of service to real expenses (footnote omitted).

It is clear, then, that the "duty" which the Court spoke of in *United,* and upon which the City's challenge here hinges, was the duty of the Commission to consider "the actual tax saving impact" of consolidated tax returns. Nowhere can there be found in *United* a duty or requirement that the Commission allocate a certain portion of the consolidated tax savings to the regulated affiliated.

Much to the contrary, this Court in *United* was careful to leave that question to the Commission in the exercise of its expert judgment. Thus, the *United* Court clearly expressed (386 U.S. at 245)(emphasis supplied):

> We think that *in the proper circumstances* the Commission has the power to reduce cost

> of service, and hence rates, based on the application of nonjurisdictional losses to jurisdictional income. Hence, the question becomes one of *when and to what extent* the tax savings flowing from the filing of a consolidated return are to be shared by the regulated company. Or, to put it in the Commission's words, the issue is one of determining "the proportion of the consolidated tax which is *reasonably attributable* to the Gas Company *vis-a-vis* [its] other * * * affiliates." 30 F.P.C., at 162.

Clearly, the Court was not predetermining the question *whether or not* certain consolidated tax savings must be shared by the jurisdictional affiliates; indeed, the Court there expressly recognized that it was for the Commission to determine, *in the appropriate circumstances*, what portion of the tax savings was *attributable to* the regulated business.

This is precisely the factual inquiry which the Commission undertook through its "stand alone" method below. Upon application of that method to the facts in this case, the Commission properly determined that only the tax savings arising out of the parent company's interest deductions were attributable to, and therefore to be shared by, the pipeline subsidiaries and their customers.

City quotes extensively from other passages in *United* in attempting to support its interpretation, but when those passages are read in their full context, it is clear that City has misconstrued that decision. Thus, City (Pet. at 14) excerpts part of the following passage in *United* (386 U.S. at 243-44) (emphasis supplied):

> *A proper allocation had to be made by the Commission.* Respondents insist that in making the allocation the Commission would violate the statute unless in every conceivable circumstance, including this one, United is allowed an amount for taxes equal to what it would have paid had it filed a separate return. *In their view United should never share* in the tax savings inherent in a consolidated return, even if on a consolidated basis system losses exceed system gains and neither the affiliated group nor any member in it has any tax liability. *This* is an *untenable position* and we reject it. Rates fixed on this basis would give the pipeline company and its stockholders not only the fair return to which they are entitled but also the full amount of an expense never in fact incurred. In such circumstances, the Commission *could* properly disallow the hypothetical tax expense and hold that rates based on such an unreal cost of service would not be just and reasonable.

Petitioner City interprets this passage to say that "it would be an 'untenable' result if a regulated pipeline collected a FIT allowance while the consolidated group of which it was a member paid no federal income taxes, while the Court of Appeals in *Charlottesville II* found this possible outcome to be 'no obstacle' to the Commission's adoption of its 'stand-alone' policy." Pet. at 14. However, the "untenable result" which the passage speaks of was clearly that the pipeline "should *never* share in the tax savings inherent in a consolidated return." *United*, 386 U.S. at 243 (emphasis supplied). As to whether the Commission *must* require the regulated pipeline to share in certain

tax savings, the passage only suggests that it "*could*" require a sharing of the savings, *i.e.*, where to do otherwise would be to base rates on an unreal cost of service (*id.* at 244)—again, a question of fact to be determined by the Commission.

City's position that *United* requires that certain tax savings be shared by the regulated pipeline's customers is, moreover, flatly contrary to the very formula at issue in *United* and with which no fault could be found in that case. Thus, under the particular formula that was before this Court in *United,* losses of the unregulated affiliates were *first* applied against the gains of the other unregulated affiliates such that: "If a net taxable income remained in the unregulated group, the regulated companies would not share in the savings from the consolidated return . . ." (386 U.S. at 241-42).

When the Commission's "stand alone" method first came under review in *Charlottesville I*, the Court of Appeals held (661 F.2d at 952) (footnote omitted):

> The Commission is not obligated to follow any particular formula for the apportionment of consolidated tax savings. The *United* ruling allowed flow-through to ratepayers but did not mandate it. *FPC* v. *United Gas Pipe Line Co.*, 386 U.S. at 246, 87 S.Ct. at 1008.

When the case returned to the Court of Appeals following the Commission's further explication of its rationale supporting the "stand alone" method, the court below in *Charlottesville II* reaffirmed that the "stand alone policy [is] consistent with the Commission's mandate" (774 F.2d at 1213, App. at 15a). This was proper.

No conflict with this Court's *United* decision is involved here. Much to the contrary, the Court of

Appeals decision only involves the application by the Commission of an allocation method to the facts of this case, fully consistent with the recognition in *United* that the Commission has the power to do so on a reasoned basis. "Under this Act the appropriateness of the [allocation] formula employed by the Commission in a given case raises questions of fact not of law." *Colorado Interstate*, 324 U.S. at 590.

II. THE COURT OF APPEALS BELOW PROPERLY REJECTED PETITIONER'S IMMUTABLE "ACTUAL TAXES PAID" PRINCIPLE

As noted (*supra* at 2), "actual taxes paid" is the purported doctrinal basis upon which City has rigidly relied in contending below that "the stand-alone methodology is *per se* unlawful" (*Charlottesville II*, 774 F.2d at 1213, App. at 15a). According to City below, the tax allowance must be computed using the overall effective tax rate that results from the consolidated tax liability, this being the only tax that is actually paid (App. at 42a, 54a). Charlottesville in effect argued that the Commission should simply apply to the regulated pipeline for ratemaking purposes a *pro rata* or average cost of income taxes incurred by the consolidated group (*id.*).

The Commission flatly rejected any such notion that average, *pro rata* taxes were required as a matter of "actual taxes paid," finding (App. at 55a):

> The method focuses solely on the total tax liability and the aggregate reduction. It is oblivious to how that liability and reduction came about. It ignores each member's income and deductions that were combined to produce that liability. But consideration of what each member has contributed is essential. Without knowing that we cannot properly as-

> sess each member's and the ratepayers' responsibility for the single tax liability. So the method need not produce – and in this case does not produce – tax allowances that reflect the tax costs the pipelines incur in providing jurisdictional service.

Evidently, City's undiscerning application of the so-called "actual taxes paid" principle likewise would be contrary to what this Court in *United* had in mind when it observed that "the issue is one of determining 'the proportion of the consolidated tax which is reasonably attributable to the Gas Company *vis-a-vis* [its] other * * * affiliates.'" *United*, 386 U.S. at 245 (citation omitted).

The Court of Appeals below soundly rejected Petitioner's notion that the Commission was so constrained by some immutable "actual taxes paid" principle, and in so doing, recounted the numerous precedents dispelling such notion (*Charlottesville II*, 774 F.2d at 1213-15, App. at 15a-20a). Petitioner City contends that the Court of Appeals erroneously relied on these precedents which, according to Petitioner, are distinguishable either because of "the generic nature of the ratemaking proceedings involved" (Pet. at 23) or because they "do not involve permanent tax savings" (Pet. at 24).

But as the Court of Appeals decision plainly reveals, City misses the point. In summing up its discussion of these precedents, the court concluded that City's concept of "actual taxes paid" in ratemaking was a misnomer of which

> two out of the three words are wrong. Taxes, yes. But not necessarily *actual* taxes, since inexact estimations are often allowed, *e.g.*, a nationwide tax allowance applied to all in-

> dividual utilities, *see Tenneco Oil*, 571 F.2d at 844. (In point of fact, of course, even the use of *actual* taxes for the test year by which future rates are calculated rarely succeeds in the objective of precisely estimating the actual taxes in the years when the rates are paid.) And not necessarily taxes *paid*, since tax liability incurred by current activities but in fact not paid currently can be charged to present ratepayers, *e.g.*, taxes deferred by reason of accelerated depreciation but passed on to current ratepayers through normalization, *see Public Systems*, 709 F.2d at 81-82. So the principle should be expressed "actual or estimated taxes paid or incurred" – whereupon it ceases to constrain the Commission with regard to taxes any more than the Commission is constrained with regard to its treatment of other expenses. Which is as it should be.

Charlottesville II, 774 F.2d at 1215, App. at 20a (emphasis in original).

The point is that the reasoning of those cases unequivocally dispels Petitioner's immutable notion of "actual taxes paid" irrespective of their factual contexts. Thus, for example, the Court of Appeals was clearly speaking of ratemaking in general when it emphatically concluded in *American Public Gas Ass'n* v. *FPC*, 567 F.2d 1016, 1038 (D.C. Cir. 1977):

> In rate regulation there is no mystique requiring that expenses be actually "paid." . . . [T]here is no historical basis for petitioners' simplistic interpretation of the "actual taxes paid" principle.

Contrary to City's position, the income tax allowance as an element of ratemaking clearly is not a

simple matter of what was actually paid. It is not a simple matter of ascertaining the "bottom line" expenditure or average effective tax rate. Rather, it is a process of segregating the various tax aspects which interact within the formulation of that bottom line so as to determine which of the components of the consolidated tax formulation are properly attributable to, and therefore allocable to, the regulated pipeline. In the words of *United* (386 U.S. at 243):

> The question for the Commission was what portion of the single consolidated tax liability belonged to United. . . . A proper allocation had to be made by the Commission.

In sum, Petitioner City's immutable "actual taxes paid" principle is oblivious to fundamental tenets of cost responsibility which the Commission, in its expert judgment, found to require the far more discerning allocation procedures embodied in its "stand alone" method. This judgment by the Commission was properly upheld by the Court of Appeals below.

III. THE "BENEFIT/BURDENS" TEST UNDERLYING THE COMMISSION'S ALLOCATION METHOD IS EMINENTLY REASONABLE

Nowhere is the reasonableness of the Commission's "stand alone" policy clearer than in its inherent matching of benefits with burdens. That is, in full keeping with basic tenets of cost responsibility, the Commission's "stand alone" method invokes the eminently fair premise that he who bears the cost burdens which give rise to the tax offsets should also reap the benefits of the lower taxes resulting therefrom.

Petitioner City attempts to obfuscate this basic truth by once again resorting to its result-oriented "actual taxes paid" theorem and contending that the

result reached by the Commission cannot be justified by the method (Pet. at 25). However, Petitioner's reliance here on this Court's well established principle that "it is the result reached and not the method employed which is controlling" clearly turns that case on its head. *FPC* v. *Hope Natural Gas Co.*, 320 U.S. 591, 602 (1944). What the Court in *Hope* clearly had in mind when enunciating the "end result" test was "that the Commission was not bound to the use of any single formula or combination of formulae in determining rates. Its ratemaking function involves the making of 'pragmatic adjustments.'" *Id.* Indeed, "[it] is the product of expert judgment which carries a presumption of validity." *Id.*

In this case, the Commission's "stand alone" method is not only presumptively valid, but as the Court of Appeals properly concluded, its reliance upon the principle that benefit follows burden "is on its face eminently reasonable." *Charlottesville II*, 774 F.2d at 1217, App. at 24a. As the court so aptly observed in another case, "[t]he justice inherent in [this principle] is self evident and . . . already occupies a niche in the law of ratemaking." *Democratic Central Committee of D.C.* v. *Washington Metropolitan Area Transit Comm'n*, 485 F.2d 786, 806 (D.C. Cir. 1973).

Semantics aside, "stand alone" is by no means an end, in and of itself. As the Court of Appeals correctly concluded below, the Commission's "stand alone" policy provides a rational basis for determining a regulated pipeline's tax allowance under the consolidated tax circumstances presented in this case. That choice of method, in the court's view,

> is an entirely reasonable one, beyond our authority to upset. *See FPC* v. *United Gas Pipe Line Co.*, 386 U.S. 237, 246, 87 S.Ct. 1003, 1008, 18 L.Ed.2d 18 (1967); *Colorado Inter-*

state Gas Co. v. *FPC*, 324 U.S. 581, 589, 65 S.Ct. 829, 833, 89 L.Ed. 1206 (1945); *Charlottesville I*, 661 F.2d at 952.

Charlottesville II, 774 F.2d at 1221, App. at 32a.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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